"Arm's length" should simply be given its plain meaning and should not carry with it the regulatory baggage associated with that term under a system of regulation abandoned over a decade ago.

The Commission also asks whether the "compensatory price" standard would be consistent with any Congressional intent that regulated service ratepayers benefit from the economies of scope from the new activities permitted by the 1996 Act.[85] In implementing the nonstructural accounting safeguards, the Commission recognized "that there may be significant efficiencies in allowing the BOCs and AT&T to intergrate their various activities, and that it is in the public interest to allow the carriers to achieve these efficiencies . . . ."[86] BOC entry into the marketplace assures that the full array of communications services is available to the entire market, including casual residential users and small businesses which might otherwise be under-served. BOC entry also stimulates additional demand for all providers' products. Further, the regulated ratepayer benefits from the economies of scope and scale achieved through such joint activities. The reason is twofold. First, it takes minimal additional resources to perform these joint activities. Second, the affiliate to which the service is provided pays the fully distributed cost of the provision of the service by the BOC, and thus contributes to the overheads and other costs which under rate-of-return regulation would otherwise be borne entirely by the ratepayer. Artificial barriers to BOC entry beyond those expressly set forth in Section 272, such as regulations that increase the cost of entry, will deny consumers the benefits of competition that Congress intended. Given the public interest benefits inherent in efficient integrated operations,

---

[85] NPRM, ¶70.

[86] Joint Cost Order, ¶39.

the Commission should not impose any additional requirements that would impede that procompetitive efficiency.

XI. <u>THE COMMISSION SHOULD NOT ESTABLISH OTHER UNNECESSARILY DETAILED REQUIREMENTS</u>.

The Commission need not adopt any rules to implement Section 272(b)(5)'s requirement that transactions between a BOC and its required interLATA or manufacturing affiliate be "reduced to writing and available for public inspection." The statute itself is sufficiently clear. The BOCs are accustomed to reducing their affiliate transaction rules to writing and publicly disclosing them. BOCs as well as other LECs, publicly disclose affiliate transactions as part of their periodic CAM filings. The 1996 Act reduced the frequency of CAM filings to an annual filing, and thus, it was the intent of Congress to reduce the burden of public disclosure requirements such as the CAM filings.[87] Consistent with this intent, the Commission should not impose detailed requirements concerning the method of making information publicly available concerning transactions with the required interLATA or manufacturing affiliate. The content of the CAM should be sufficient to meet the intent of Congress.[88]

The <u>NPRM</u> also asks whether the Commission needs to "adopt safeguards to protect any sensitive or confidential information"[89] that these transactions might contain. It is not necessary for the Commission to adopt special rules concerning protection of sensitive or confidential information so long as the customary rules concerning protection of such information are

---

[87] Section 402(b)(2)(B) of the 1996 Act.

[88] It is certainly not necessary or appropriate to require public disclosure of transactions through the Internet, as suggested in the <u>NPRM</u>.

[89] <u>NPRM</u>, ¶ 74.

applied. These rules are currently being examined in GC Docket No. 96-55.[90] The principles being examined there must be sufficient to permit a BOC to protect any competitively sensitive or confidential information that these affiliate transactions might contain.[91]

It is also unnecessary, and contrary to the deregulatory spirit of the 1996 Act, for the Commission to adopt any new disclosure requirements in connection with Section 272(e)(1)'s requirement that a BOC "fulfill any request from an unaffiliated identity for telephone service and exchange access service within a period no longer than the period in which it provides such telephone exchange service and exchange access service to itself or its affiliates." The complaint process is more than sufficient to enforce this requirement and, unlike Section 272(b)(5), this Section does not even mention any "public inspection" requirement. In any event, such tariffed services are governed by specific regulations and the tariff should satisfy any documentation or disclosure requirements.[92]

XII. THE COMMISSION SHOULD NOT ESTABLISH ACCOUNTING REQUIREMENTS FOR THE COMPETITIVE SEPARATE AFFILIATES OTHER THAN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES.

SBC concurs with the NPRM's suggestion that the affiliates required by Section 272 should maintain their financial records in accordance with Generally Accepted Accounting

---

[90] Examination of Current Policy Concerning the Treatment of Confidential Information Submitted to the Commission, GC Docket No. 96-55, Notice of Inquiry and Notice of Proposed Rulemaking, released March 25, 1996.

[91] See SBC Comments, CC Docket No. 96-55, filed June 14, 1996, at 8-11.

[92] SWBT also adopts and supports USTA's position regarding the audit and compliance review required by Section 272 and Section 274, respectively. There is nothing unique in the statutory language that would justify detailed rules concerning the scope of these audits or compliance reviews. Instead, the scope should be determined by the independent auditor in accordance with Generally Accepted Auditing Standards.

Principles (GAAP). It is not necessary or appropriate for the Commission to establish any additional accounting, bookkeeping or recordkeeping requirements. The requirement, applicable generally to LECs, to maintain a complete audit trail of all affiliate transactions is more than sufficient for purposes of the 1996 Act and for purposes of Commission audits.[93]

The NPRM also inquires as to whether cost allocation rules should be applied to the Section 272 interLATA affiliate "to prevent subsidization of nonregulated activities . . . by subscribers to interLATA telecommunications services."[94] SBC is baffled by the suggestion to apply cost allocation rules to a competitive start-up interLATA telecommunications affiliate. That interLATA affiliate will have no market power and should be subject to streamlined regulation, if any. The Commission has not found it necessary to impose any such requirements on other interLATA carriers, and thus it is clear that subscribers of interLATA carriers do not require protection from cross-subsidy. Given that all of the services and products to be provided by the interLATA carrier will be competitive, the competitive market forces will be more than sufficient to protect that carrier's subscribers. For cross-subsidy to be an issue, the provider must possess market power - a circumstance not present at an unregulated affiliate. Besides, cost allocation rules, like all other aspects of dominant carrier regulation, would serve as a barrier to rather than a facilitator of, competition.[95]

---

[93] Joint Cost Order, ¶242.

[94] NPRM, ¶90.

[95] See SBC Comments, CC Docket No. 96-149, filed August 15, 1996, at 17-19.

XIII. THE AFFILIATE TRANSACTION RULES ARE SUFFICIENT FOR PURPOSES OF ANY SECTION 274 "SEPARATED AFFILIATES".

The existing affiliate transaction rules are more than sufficient to protect the ratepayers of a BOC's regulated services against cross-subsidy in connection with any transactions with the "separated affiliate" or any other affiliated entity established pursuant to Section 274. It is not necessary for the Commission to adopt any special rules or procedures in connection with such Section 274 affiliates. Of course, even these affiliate transaction procedures are not necessary under price cap regulation and similar state methods of regulation because these provide sufficient protection against cross-subsidy.

Even though no rule changes are necessary, the Commission should recognize that the existing affiliate transaction rules would not apply to certain "separated affiliates" and joint ventures in which the BOC has an insufficient ownership interest to exercise the control required to consider them to be "affiliates" under the definition in Part 32.[96] Of course, the existing affiliate transaction rules recognize that a noncontrolling interest substantially reduces, or eliminates, the potential for any cross-subsidy by virtue of the even greater degree of independence that such a noncontrolled entity would have.

XIV. THE SECTION 274(f) REPORTING REQUIREMENT SHOULD BE SIMPLE.

The NPRM seeks comments on what reporting requirement it should adopt under Section 272(f) "to minimize burdens on the filing companies."[97] The Commission should adopt a simplified version of the Form 10-K that contains unaudited financial statements and brief

---

[96] See, 47 C.F.R. §32.9000, Glossary ("Affiliated Companies").

[97] NPRM, ¶108.

description of the company and its operations. The financial statements are the core components of a Form 10-K and should fulfill the reasons for requiring this report. Audited financials, which might not be needed otherwise, are not necessary for purposes of Section 274(f). The separated affiliate should be allowed to protect sensitive or confidential information contained in such reports pursuant to the customary procedures for protecting such information submitted to the Commission.

XV. EXOGENOUS TREATMENT OF INVESTMENT COST REALLOCATION DUE TO TELEMESSAGING NONREGULATED USE WOULD BE IMPROPER.

SBC agrees with the Commission that the "rules [the Commission] adopt[s] to prevent the subsidies prohibited by Sections 260 and 271 through 276 of the 1996 [Act] will be shaped by [its] price cap regulations."[98] Under the system of pure price cap regulation currently applicable to SWBT and a number of other LECs (which the Commission should adopt permanently), any remaining hypothetical incentive or ability to subsidize nonregulated services at the expense of regulated services are not present. Under these circumstances, accounting safeguards such as the cost allocation and affiliated transaction rules are not necessary. The 1996 Act also impliedly recognizes that any need for safeguards is short-term in view of the limited duration of the structural safeguards in Sections 271 through 274.

In view of the limited duration and relevance of the accounting safeguards under the system of price regulation now in effect and planned for the future, the Commission should not retain any of the linkage between costs and prices, such as the NPRM's suggested application of the exogenous cost rule as a result of provision of telemessaging service utilizing common

---

[98] Id., ¶ 121.

network investment.[99] In any event, exogenous cost treatment as a result of the provision of telemessaging service would be improper because of the limited purpose of the exogenous cost rule in Section 61.45(d)(1)(v). Several commenters in CC Docket No. 96-112, the Video Cost Allocation NPRM, pointed out that the purpose of the exogenous cost rule in Section 61.45(d)(1)(v) is very limited. Initial price caps indices were approved by the Commission and established based on accounting costs as of 1990. Given the endogenous nature of LECs' investment decisions, Section 61.45(d)(1)(v) was never intended to apply to the allocation of new investment placed after 1990 or to other post-1990 changes in the costs of regulated and nonregulated investment. Rather, it was intended to deter under-forecasting of nonregulated usage pursuant to Section 64.901(b)(4).[100] The Commission should reject any suggestions, such as those made by commenters in CC Docket No. 96-112,[101] to interpret Section 61.45(d)(1)(v) to require a price cap adjustment for all reallocations of network investment from regulated to nonregulated activities as a result of telemessaging or other services.[102]

XVI. CONCLUSION

The existing accounting safeguards are more than sufficient for purposes of any cross-subsidy concerns related to Sections 260 and 271 through 276 of the 1996 Act. However, under price caps and similar forms of incentive regulation, these accounting safeguards are not necessary to prevent cross-subsidy at the expense of regulated customers. At a minimum, the

---

[99] Id., ¶123.

[100] See, e.g., Bell Atlantic Comments at 7; BellSouth Comments at 11; Pactel Comments at 18; NYNEX Comments at 22, in CC Docket No. 96-112, filed May 30, 1996.

[101] Cf. AT&T at 10-11, MCI at 16, CC Docket No. 96-112, filed May 30, 1996.

[102] See also Christensen, attached as Exhibit "A", at 6-7.

Commission should consider streamlining the existing accounting safeguards in order to ease the burden of these regulations. If the Commission chooses not to forbear or streamline at this time, the Commission should be guided by the NPRM's tentative conclusion that the existing accounting safeguards generally satisfy any requirements of the 1996 Act. Thus, the Commission should not make any changes that fundamentally alter the approach to the accounting safeguards or impose unnecessary regulatory burdens, such as the adoption of special allocation rules or categories for interLATA costs, the imposition of subjective fair market value studies as an additional layer of regulation in the valuation of affiliate services, and the elimination of the objective prevailing price test. The Commission should minimize the burden of its regulations and refrain from adopting other regulations that are not necessary in the public interest. For the reasons set forth in these Comments, these and other onerous or intrusive regulations are not required by the 1996 Act and are not justified in the current competitive and regulatory environment.

Respectfully Submitted,

SBC COMMUNICATIONS INC.

By Jonathan W. Royston

James D. Ellis
Robert M. Lynch
David F. Brown
175 E. Houston, Room 1254
San Antonio, Texas 78205
(210) 351-3478

ATTORNEYS FOR SBC
COMMUNICATIONS INC.

Durward D. Dupre
Jonathan W. Royston
One Bell Center, Room 3520
St. Louis, Missouri 63101
(314) 235-2507

ATTORNEYS FOR SOUTHWESTERN BELL
TELEPHONE COMPANY

August 26, 1996

EXHIBIT "A"

UNITED STATES
TELEPHONE
ASSOCIATION

July 17, 1996

William F. Caton
Secretary
Federal Communications Commission
1919 M Street, NW
Room 222
Washington, D.C. 20554

Dear Mr. Caton:

RE: Ex parte Filing, CC Docket No. 96-112 & CC Docket No. 94-1

USTA hereby files the enclosed document authored by Dr. Laurits R. Christensen, Christensen Associates, entitled ***Treatment of LEC Investments in Joint-Use Broadband Facilities Under a Price Cap Regime***. Dr. Christensen has been a principle co-author of USTA's position on price cap regulation in CC Docket No. 94-1 and is a recognized expert and author on the subject.

The purpose of this document is to explain why LEC investments do not require special cost allocation or exogenous price cap adjustments. As stated in detail in Dr. Christensen's paper, price cap regulation protects customers of regulated services without a need to allocate costs or adjust rates, and also allows those customers to benefit from investment in new technologies, including economies of scope.

Please include a copy of this filing in the record of each proceeding.

Respectfully submitted,

Keith Townsend

Keith Townsend
Director
Regulatory Affairs & Counsel

Attachment

cc: Chairman Hundt
Commissioner Quello
Commissioner Ness
Commissioner Chong
FCC Staff

Treatment of LEC Investment In Joint-Use Broadband Facilities Under a Price Cap Regime

Laurits R. Christensen
July 16, 1996

As telephone companies move forward with plans to deploy new technologies to improve existing services and offer new services, concern has been expressed that customers of regulated traditional telephone services will be forced to pay for such network upgrades without receiving the benefits from any resulting economies of scope -- the lower level of cost due to producing a range of products using the same facilities instead of producing the products separately. In response to this concern, proposals have been made to somehow adjust the price cap mechanism based on an arbitrary allocation of costs of these new technologies between the traditional regulated services and new video or other nonregulated services. Any such allocation is unnecessary under a price cap regime without sharing, and it is certainly improper to adjust prices to reflect the removal of costs that were never included in the setting of rates. Moreover, any economies of scope can be fully captured by an appropriate price cap formula.

This concern and the proposals that stem from it are, in reality, artifacts of rate-of-return regulation and are misplaced under price cap regulation. As described in this paper, price cap regulation protects customers of regulated services without a need to allocate costs or adjust rates, and also allows those customers to benefit from investment in new technologies, including economies of scope. Below I explain why local exchange carrier ("LEC") investments do not require any special cost allocation or exogenous price cap adjustments.

1. In a Price Cap Regime Without Sharing, Cost Allocations or Changes in Cost Allocations Have No Effect on Prices. In a price cap system of regulation without sharing, prices are capped by a formula that has two basic ingredients: a measure of overall inflation in the economy, and an offset to the inflation measure (the "X factor"). Prices paid by the customer are directly regulated by the price cap formula -- i.e., regulated prices cannot rise above the ceiling (the price cap index) established by the price cap formula. This is unlike rate-of-return regulation where prices are indirectly regulated through the authorized rate of return and depend largely on allocations of revenue requirements to services.

Once starting rates for the price-capped services have been established, prices of those services are regulated by the price cap formula, not by allocations of the telephone company's costs. Moreover, the price cap mechanism prevents telephone companies from passing cost increases through to customers via higher rates. In other words, independent of any cost increases incurred by the company, the prices paid by customers for regulated services are capped by the index. Thus, a company's investment decisions concerning broadband facilities will not affect prices for price capped services, contrary to standard practice under rate-of-return regulation.

2. The Measurement of Total Factor Productivity (TFP) Captures the Benefits of Economies of Scope. When the offset to inflation in the price cap formula is based on the differential between LEC productivity growth and economy-wide TFP growth, higher rates of LEC productivity growth lead to a higher X factor and lower rates of LEC productivity growth lead to a lower X factor.

In the current review of LEC price cap regulation (CC Docket 94-1), the Commission tentatively concluded that economically meaningful TFP should be used as a basis for the price cap formula. My TFP study of the LEC industry has been put forward by the USTA for purposes of setting the appropriate X factor. My study is based on the total company results, as defined by the Commission's Part 32 accounting rules. The Part 32 accounting rules take an economic approach to measuring revenue and expense. Specifically, Rules 32.23 and 32.4999 specify that the company accounts include not only all regulated services, but also all nonregulated services that have joint and common costs with regulated services. Other Commission accounting rules, such as Part 64 and Part 36, base cost calculations on allocation rules. The joint and common cost concept has a well-defined economic meaning while arbitrary allocation rules have no foundation in economics. For this reason, I based my LEC TFP study on the Part 32 accounts rather than the Part 64/Part 36 allocated portion of these accounts.

Services with joint and common costs generally have "economies of scope." Economies of scope for different services occur when the cost of providing those services jointly is lower than the cost of providing them from separate facilities. If regulated and nonregulated services have joint and common costs, a company will generally have higher TFP if it offers both the regulated and nonregulated services, rather than just offering the regulated services. This is because TFP measures the ratio of Total Output to Total Input.

Because the TFP growth differential is the offset to inflation in the price cap formula, higher LEC TFP growth (all other factors held constant) results in a lower ceiling on regulated prices. Thus, to the extent that joint and common facilities produce greater output of either regulated or nonregulated services, the customers of regulated services are better off.

3. LECs Investment in Broadband Facilities Should Result in Higher Measured TFP Growth. LEC investment in broadband facilities will be used to produce both regulated services and nonregulated services, such as video. Other parties in CC Docket 96-112 have expressed concern that investment in broadband facilities will lead to rate increases for customers of traditional regulated services. This concern stems largely from taking a rate-of-return/cost allocation perspective on the process and it ignores how price cap regulation works. As noted above, when services are regulated by price caps without sharing, such investments or changes in cost allocations do not have an impact on the price cap formula.

Given the current Part 32 rules, these broadband facilities and the services produced by them will be included in the computation of TFP. Therefore, investment in these types of facilities has the potential to increase TFP growth and, in a price cap regime, will benefit customers of regulated services.

However, even under price cap regulation, some parties in CC Docket 96-112 question whether investments in broadband facilities may become a "drag" on TFP growth and, thus, cause the price cap ceiling for regulated services to become higher than it would otherwise be. For example, some parties have claimed that the investments required to deploy broadband facilities will result in lower TFP growth, at least initially. This, they argue, would eventually lead to a lower X factor, a higher price cap ceiling and, thus, the potential for higher regulated rates. This concern is misplaced for several reasons.

First, it must be understood that incremental investment in broadband facilities would only be a small portion of total LEC investment and would have a relatively small impact on the overall level of TFP. TFP is the ratio of Total Output to Total Input. Capital Input, which includes all plant and equipment in service used in the provision of telephone service (i.e., the total stock of capital), accounts for less than half of the cost of Total Input. In any given year, gross additions to plant and equipment accounts for only about 7 percent of plant and equipment in service. Thus, even large increases in new investments can have only a minor impact on Capital Input and Total Input in the calculation of TFP.

Second, any impact of broadband facility investment on LEC TFP growth will be minimized by the fact that the investments are likely to be phased in over time and not all installed immediately. Because these investments will be spread over a number of years, the annual impact of broadband facility investment on total investment (total plant added) will not be large. Furthermore, because Capital Input in the TFP calculation is based on total plant in service, the impact of this broadband investment on the TFP Total Input calculation will be even smaller.

A numerical example can show the likely magnitude of broadband facility investment on the growth in Total Input. Suppose that broadband facility investment increases gross additions by 10 percent. This would lead to approximately a seven tenths of one percent increase in capital. Since capital constitutes approximately 45 percent of Total Input, Total Input would increase by only three tenths of one percent.

Moreover, this increase would be offset by any expense savings associated with the deployment of fiber and other advanced technologies. Thus, the net impact of these investments on Total Input (the combination of Capital, Labor and Materials) is likely to be minimal.

Finally, the impact of these investments on TFP must also consider the additional revenues generated by services that use these facilities. Up to this point, I have discussed the worst-case scenario--i.e., the impact of investment in broadband facilities on TFP with no corresponding increase in revenues from either existing services or new services, such as non-regulated video services, made possible by the investments. It is important to understand that all revenues from services that rely on the new joint-use technology, including non-regulated video services, contribute to Total Output in the calculation of TFP. Any source of revenues has the impact of further increasing TFP growth, and thereby reducing the price cap index. The relative success of the new video venture only impacts the size of the downward pressure on regulated rates, not the direction.

4. An Exogenous Adjustment to the Price Cap Formula to Remove Portions of Broadband Investment is Not Warranted. Other parties commenting in CC Docket 96-112 have also argued that the LECs should make an exogenous cost adjustment to lower the price cap index to reflect the "removal" of common costs allocated to nonregulated video services. Such an adjustment would lower the price cap index directly, in addition to any reduction mandated by the price cap productivity formula.

Again this is a retreat to rate of return/cost allocation type regulation and is economically flawed.

First, to the extent such investment was undertaken after adoption of price caps, the adjustment would "remove" costs that were not included in the initial rates going into price caps. The only legitimate way to remove such costs exogenously would be first to add them in as an exogenous adjustment. Second, as explained above, adoption of a TFP formula fully captures the economies of scope associated with the new investment. An exogenous adjustment would double-count that same impact and penalize LECs that make such investment. In contrast to the appropriate incentives of price cap regulation, the result of such a policy would be to discourage making productivity enhancing joint-use investment.

5. Conclusion. Today's price cap formula protects customers of regulated services from bearing the cost of investments in nonregulated services. The LEC industry proposal for a TFP based formula would allow those same customers to fully share in the economies of scope associated with the joint use investment. Mandating an exogenous cost adjustment based on allocation to that investment would double-count those benefits, and discourage making the investment in the first place -- harming customers of both regulated and nonregulated services.

CERTIFICATE OF SERVICE

I, Katie M. Turner, hereby certify that the foregoing, "Comments Of SBC Communications Inc." in CC Docket No. 96-150 has been filed this 26th day of August, 1996 to the Parties of Record.

Katie M. Turner

Katie M. Turner

August 26, 1996

ITS INC
1919 M STREET NW
ROOM 246
WASHINGTON DC 20554

JANICE MYLES
FCC
COMMON CARRIER BUREAU
1919 M STREET NW RM 544
WASHINGTON DC 20554

DOROTHY CONWAY
FEDERAL COMMUNICATIONS COMMISSION
1919 M STREET NW - RM 234
WASHINGTON DC 20554

TIMOTHY FAIN
OMB DESK OFFICER
10236 NEOB
725 - 17TH ST NW
WASHINGTON DC 20503